Asia Credit Research

Earnings Review: Sembcorp Industries Ltd ("SCI")

Issuer Profile: Neutral (4)

Ticker: **SCISP**

Background

Sembcorp Industries Ltd ("SCI") was formed via the merger of Singapore Technologies International Corporation and Sembawang Corporation in 1998. SCI is focused on utilities (energy and water solutions), offshore marine (via its 61%-stake in Sembcorp Marine Ltd ("SMM")) and urban development (focused on the development of industrial parks across the region). Temasek is the largest shareholder of SCI with a 49.5%-stake

Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

Recommendation

- While SCI's core utilities business saw a 7% y/y decline in 4Q2018, encouragingly the Utilities-India segment had turnaround. Additionally, Sembcorp Marine Ltd ("SMM") has become less of a drag to SCI's credit profile. While orderbook at SMM has not been replenished, this is a credit positive to SCI in our view, particularly for the short end of the curve. Overall, SCI's credit profile has not improved decisively; nonetheless, we are comfortable maintaining its Issuer Profile at Neutral (4) as we do not expect a decline over the next 12 months.
- At the short-end, we prefer the SCISP 3.7325% '20s over the Keppel Corp Ltd ("KEP") KEPSP 3.1% '20s with the former offering a spread pick-up of 11bps over the latter for a six months shorter time to maturity. While KEP's net gearing is still low at 0.48x, we expect this to tilt up with KEP's pending investment outlay in M1, KPTT, IXOM and expanding its asset management arm.
- Although less liquid, we prefer the SCISP 4.75%-PERP over the SCISP 3.7%-PERP. The SCISP 3.7%-PERP faces first call in June 2020, although there is no step-up. The SCISP 3.7325% '20s is trading at 2.65% and assuming a senior-swap spread of 100-120bps, an implied perpetual with first call in 2020 may come with a cost of ~3.7-3.9% p.a, leaving little economic incentive in our view for SCI to call this perpetual at first call. Conversely, we think there is a good chance for the SCISP 4.75%-PERP to be called at first call in April 2020. While similarly there is no step-up, we think SCI is able to replace this perpetual at a lower cost of funding. We hold both SCI and KEP's issuer profile at Neutral (4).

Relative Value:

Bond	Maturity/Call date	Reset date	Net gearing	Ask YTM/ YTC	Spread
SCISP 3.7325% '20s	09/04/2020	NA	1.1x	2.70%	72bps
SCISP 4.75%-PERP	20/05/2020	20/05/2025	1.1x	4.39%*	241bps
SCISP 3.7%-PERP	22/06/2020	22/06/2022	1.1x	4.11%*	214bps
KEPSP 3.1% '20s	12/10/2020	NA	0.48x	2.53%	57bps

Indicative prices as at 22 February 2019 Source: Bloomberg
Net gearing based on latest available quarter; reset date does not equal first call date for both the perpetuals
**Yield to Reset for SCISP 4.75%-PERP is at 4.71% while for the SCISP 3.7%-PERP is at 3.87%*

Key Considerations

- **Top line improved in 4Q2018:** Gross revenue was higher by 6.7% y/y to SGD2.6bn on the back of a 13% (y/y) increase in Utilities revenue, while the Marine segment (61%-owned Sembcorp Marine Ltd ("SMM")) saw a marginally higher revenue growth. These help offset the lower revenues at Urban Development and Others (collectively these two segments makes up a quarter of net profit). Utilities revenue was boosted by stronger performance in Singapore, Teeside (centralised utilities provider in Northeast England) and contribution from UK Power Reserve ("UKPR"), a flexible distributed energy generator which was acquired in June 2018 for ~SGD386mn. General & administrative expenses were 30% lower in 4Q2018 at SGD94mn, although 4Q2017 included a SGD25mn provision for potential fines and claims at an overseas water business. An additional SGD25mn in provision in relation to the same matter was taken in 3Q2018 instead.

- **Interest coverage lower:** Finance costs were SGD152mn, increasing by 21% y/y, from a combination of higher average debt balance (including those consolidated from UKPR) and we think also from higher cost of financing. Overall profit before tax was SGD96mn while net profit to owners was SGD106mn for 4Q2018 (SGD186mn and SGD118mn respectively in 4Q2017). EBITDA (based on our calculation without accounting for other income and other expenses) was SGD297mn (down 13.2% y/y), coupled with higher cost, EBITDA/Interest coverage was lower at 2.0x (4Q2017: 2.7x).

- **Turnaround in Utilities- India though Overall Utilities fell in 4Q2018:** In 4Q2018, Overall Utilities made up SGD64mn of net profit before exceptional items. The remaining was largely from Urban Development. Utilities – Singapore continue to be the largest net profit contributor to Overall Utilities at 47%. In 4Q2018, net profit fell 17% y/y to SGD30mn although for the full year the decline was smaller at 5%. SCI's Singapore centralised utilities (ie: on Jurong Island) and Gas business (eg: sourcing, importation and trading) did well although its power generation business continue to drag due to significant competition. Encouragingly, the losses at Utilities – India had narrowed. In 4Q2018, this was a net loss of SGD6mn against a net loss of SGD35mn in 4Q2017 while for the full year, Utilities – India posted a net profit of SGD87mn (2017: net loss of SGD58mn). We think this was driven by an increase in India wholesale electricity prices in 2018 from both higher demand and lower supply (driven by lack of coal at certain plants). Utilities UK & the Americas saw a net profit of only SGD9mn in 4Q2018 despite the acquisition of UKPR (4Q2017: SGD13mn). Per company. UKPR incurred a restructuring cost of SGD4mn in 4Q2018 and also a negative impact from a temporary suspension in the UK market on payments on available capacity. In November 2018, The European Court of Justice took issue with payments by the UK government to power generation companies as these were deemed as illegal state aid. As a result, such payments were temporary suspended until the approval is won. All in all, until there are further updates, we assume that UKPR is detracting from SCI's bottom line over the next 12 months. China net profit was down by SGD20mn in 4Q2018 to SGD17mn, which could be due to deferred tax adjustments (which are non-cash). Utilities – Corporate Costs reduced by SGD30mn to only SGD2mn which significantly helped boost net profit for the quarter. Taking out Utilities – Corporate Costs, we find the underlying Utilities net profit to have fallen by SGD5mn (7% y/y).

- **SMM less of a credit drag to SCI in 4Q2018:** Revenue was up slightly by 0.2% y/y to SGD913.2mn mainly due to revenue recognised on new projects, mitigated by lower revenue recognition from offshore platform projects. On a y/y basis, reported gross profit was down 85% to SGD19.9mn. Reported gross profit margin was 2.2%, this compares very favourably against 3Q2018's -1.1%. We think q/q is more representative for this quarter given that 4Q2017 revenue (and also, gross profit) was boosted by entitlement to downpayment on termination of rig contracts. Finance cost though remained high at SGD27mn, where operating profit of SGD2.0mn was insufficient to cover finance cost. Net gearing as at 31 December 2018 was still high at 1.4x and SMM had raised new debt to help fund investments (+SGD289mn of net increase in debt), finance costs and operations though the debt was not fully used during the same quarter. Loss before tax (before accounting for a tax credit) narrowed significantly to SGD5.6mn against SGD35.0mn in 3Q2018. While the operating environment looks to be more stabilised, it has yet to recover decisively. Net order book (excluding Sete Brasil contracts) was SGD3.09bn in end-2018 against SGD3.26bn as at 30 September 2018 (end-2017: SGD4.45bn), indicating that SMM had yet to replenish its net order book. From SCI's short-term credit perspective, the reduction in net order book is not a negative outcome as this lowers likelihood for working capital required at SMM. As a further credit positive, SMM is due to receive SGD1.1bn in cash from Borr Drilling over the next five years (from rigs sold and already delivered by SMM). The exact payment schedule is not disclosed though the last payment will be received in 1Q2024.

- **Raised additional debt though not fully used during the quarter:** As at 31 December 2018, net gearing was 1.1x, relatively flat q/q. Despite reporting a net profit, SCI's book value of equity was eroded by a comprehensive loss of SGD157mn, largely due to losses on fuel oil, currency and interest rate hedges. 4Q2018 cash flow from operations (before interest and tax) was SGD407mn while net investing outflows was SGD147mn. While SCI incurred capex of SGD329mn and spent SGD55mn investing more into joint ventures and associates, during the quarter, it also received SGD194mn in proceeds from the disposal of non-core assets (including proceeds from sale of other financial assets and business). As a recap, SCI has targeted SGD500mn in disposals (~SGD300mn to go by 2020). SCI took on new borrowings of SGD1.4bn during the quarter of which SGD968mn went towards repayment of debt and perpetuals distribution.

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Treasury Advisory	**Credit Research**
Corporate FX & Structured Products Tel: 6349-1888 / 1881 **Interest Rate Derivatives** Tel: 6349-1899 **Investments & Structured Products** Tel: 6349-1886 **GT Institutional Sales** Tel: 6349-1810	**Andrew Wong** +65 6530 4736 WongVKAM@ocbc.com **Ezien Hoo, CFA** +65 6722 2215 EzienHoo@ocbc.com **Wong Hong Wei, CFA** +65 6722 2533 wonghongwei@ocbc.com **Seow Zhi Qi** +65 6530 7348 ZhiQiSeow@ocbc.com

Explanation of Issuer Profile Rating ("IPR") / Issuer Profile Score ("IPS")

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings ("IPR") into a 7 point Issuer Profile Score ("IPS") scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold financial interests in the above-mentioned issuer or company as at the time of the publication of this report.

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